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CURRENT ISSUES IN AGRICULTURAL FINANCE: INTEREST RATES AND SAVINGS MOBILIZATION

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INTRODUCTION

Mr. Chairman, and Ladies and Gentlemen. I am at a double disadvantage in presenting this paper. First, we have just finished an excellent lunch and we've all eaten too much for good concentration this afternoon. Second, some of you have heard Dale Adam's well-polished presentation on these issues, and his is a tough act to follow. Dale loves to discuss these topics and does an excellent job of it. Unfortunately, illness in the family prevented him from attending this Workshop.

Since we have little time this afternoon to fully develop a complicated argument, I'm going to present only the basic outline of the arguments relying on Dale's work and encourage you to consult his publications for further details. His arguments can be found in the following papers: "Policy Issues in Rural Finance and Development", "Small Farmer Credit Programs and Interest Rate Policies in Low-Income Countries", "Recent Performance of Rural Financial Markets in Low Income Countries", and "A Critique of Traditional Agricultural Credit Projects and Policies".[1/]

1/ Complete references are given at the end of the paper.

The central argument is this: In spite of the wide variety of institutions, policies and programs found in many countries, rural financial markets are not performing in a satisfactory manner. In fact, Dale has referred to most of them as failures. The reason for the poor performance is that in spite of the uniqueness of any specific program in any specific country, most programs are built on a common or similar set of assumptions and policies. It is precisely the nature of these assumptions and policies which contribute to the failure of the financial markets. A new strategy or approach to rural financial markets is required if they are to function in a more satisfactory manner.

ANALYSIS OF CURRENT STRATEGIES

The basic strategy used by many low-income countries regarding their rural financial markets has been referred to as a "supply-led" approach to financial development. That is, financial services are expanded with the expectation that economic development will then follow. In the area of agriculture, the expectation is that increased agricultural credit will lead to increased output, employment, income exports or whatever macroeconomic goal policy-makers have in mind.

Given this view, governments attempt to increase the quantity of financial services in rural areas and/or reduce the cost (interest rates, etc.) of such services. There are seven methods that countries frequently employ:

1. Create new specialized lending institutions for agriculture and/or small farmers.

2. Increase the aggregate supply of loanable funds for existing formal lenders through rediscount arrangements with central banks, foreign loans, and other means.

3. Nationalize commercial banks and attempt to then direct them to lend to specific priority sectors.

4. Establish lending quotas such as Thailand's policy whereby commercial banks are required to lend 13 percent of their deposits to agriculture.

5. Specify loan size limits and thereby try to force lenders to alter the size distribution of their loans.

6. Entice lenders to make agricultural loans by risk reducing measures such as loan guarantees and crop insurance.

7. Establish differential lending rates where a) the rates for agriculture are set lower than those for nonagricultural lending, and b) set the rates for certain types of loans (such as loans to small farmers) at especially attractive levels.

What are the problems with these methods? Why do we conclude that rural financial markets are not performing satisfactory? Or are even a failure? Ten problems are fairly common.

1. In spite of the objective of increasing credit supplies, in countries such as the Philippines and the Dominican Republic (and perhaps eventually in Thailand), the nominal value of the

agricultural credit portfolio fails to keep pace with inflation. In other words, the real amount of agricultural credit lent or outstanding declines.

2. Many institutions face serious loan repayment problems which contributes to the decline in volume of credit.

3. Lenders systematically resist expansion of their loan portfolio into agriculture.

4. The agricultural lending which does take place is largely concentrated among large farmers.

5. Most agricultural lending is short-term with little increase in medium or long-term loans.

6. Rural savings capacity is assumed limited so little effort is made to mobilize voluntary savings.

7. Although interest rates are set at low levels, non-interest costs imposed on borrowers by bureaucratic procedures raises costs so much that it may be cheaper to borrow from the so-called "usurious moneylender".

8. Rural financial markets are fragmented: they serve only a specific class of borrowers and there is limited competition among institutions or between formal and informal sources.

9. Rural financial markets contribute to the worsening distribution of income experienced in many countries.

10. Relatively few financial innovations are being tried. There is little experimentation and little opportunity for an innovation to spread beyond a pilot basis.[2/]

[2/] The paper by Gary Adams to be presented in this session will explain an interesting agricultural credit experiment currently underway in Bangladesh.

To summarize the current situation then, few farmers are benefitting from the credit, much is not being repaid and the total volume of agricultural credit is not rising in spite of large programs and foreign loans. Many lending institutions are in bad financial condition, several have failed and have been taken over by a new institution, given a fresh injection of funds, and now the new institution is in trouble. Farmers that are lucky enough to get loans, get behind in their payments, learn that governments rarely force collection, and know that even if they are denied more credit, in a few years another institution will come along and lend to them. Nonpayment of loans is becoming acceptable, irresponsibility is becoming legitimized, and politics are increasingly entering the normal business process of lending and repaying loans.

Since the problems are similiar in so many countries, it is logical to look for common explanations. The following reasons seem to be behind many of the problems.

1. Many of the new specialized institutions have access to and depend on "cheap" money. Frequently the government that creates them does not expect that they should go into the financial market and compete for savings. Instead, a line of credit is provided by the Central Bank, the government provides a large share of the equity capital, and low interest foreign loans are obtained. Thus, the lender gets accustomed to a cheap source of funds, rural persons are denied the possibility of saving where they borrow, and borrowers develop little sense

of responsibility for the institution since their savings are not invested in it.

2. Most countries use subsidized interest rates for their agricultural lending. That is, the rate set for agricultural loans is less than for other sectors, is usually below a rate which might represent equilibrium, and frequently the nominal rate is below the rate of inflation. These subsidized rates create five problems. First, negative interest rates imply the real value of the agricultural portfolio declines even if all loans are repaid. Second, the rates are frequently set so low that lenders have few incentives to lend. Third, when interest rates are set lower for small farmer loans than loans to large farmers, the lenders obviously concentrate their loans among large farmers. Fourth, lenders try to concentrate their lending in short-term maturities so the funds can be relent to other sectors generating more revenue. Fifth, when interest rates are set very low, there is excess demand as borrowers attempt to borrow more than lenders prefer to lend. This leads to some type of nonprice rationing of loan funds. Expensive procedures must be used to try to police the use of loan fund and prevent diversion to other than approved uses.

3. Most lenders distrust their borrowers and feel they, rather than the farmers, know best what should be done with the loan funds. Thus they develop "approved" purposes for loans and procedures to ensure approved useage. These procedures, however, raise the lender's costs of operations, raise borrowing

costs to the borrower, and formal credit becomes less valuable than informal credit with fewer strings attached. Thus farmers tend to repay informal loans, while letting formal ones go delinquent.

NEW STRATEGY FOR RURAL FINANCIAL MARKETS

The poor performance of financial markets has led a number of analysts to argue for a fundamental overhaul in approach. Dale and others have argued for a four-part strategy to correct some of the current problems.

Savings mobilization rather than credit allocation is the focus of the new strategy. The research of Dale and others has led them to believe that savings capacities in rural areas are far greater than previously assumed.[3/] What is required is greater access to sound financial institutions which pay attractive rates on savings. Households would benefit by being able to convert unproductive investments of gold, jewelry and excess inventories into productive financial assets. This would give an opportunity for poor people to save whereas they have been traditionally ignored by urban-oriented savings institutions. It would also give them a vested interest in their financial intermediary and make them more concerned about repayment of loans.

3/ Adams' research has focused largely on Taiwan and Korea. Yunus' paper presented in this Workshop also implies a high rate of return on rural investments in Bangladesh.

A second part of the strategy is to employ higher and more flexible interest rates. If attractive rates are paid on savings, the interest rate must go up on lending. A sufficient margin or spread must be available for the lender to cover costs. Prices or interest rates, rather than noninterest means, would be used to allocate loans. Rather than as currently assumed, farmers are less likely to be concerned about interest rates and more concerned about total borrowing costs and overall reliability of the lender. Furthermore, it is expected that the rate of return on investments in rural areas is higher than normally assumed.

Third, greater emphasis is required on reducing borrowing costs. As controls are reduced and procedures streamlined, formal loans will become more valuable and farmers will be more concerned about repayment. Borrowing costs may actually be lower even though interest rates increase.

Fourth, incentives rather than controls should be used more freely to encourage a broader range of institutions to provide credit and savings services in rural areas. Less concern should be given to specialized institutions. Rather, the impediments that lenders presently face which prevent offering broader services should be identified, and reduced or removed. It is possible that the stereotype of the conservative lender uninterested in lending to agriculture is really a result of improper incentives.

CONCLUSION

In this paper I've briefly outlined the problems of many rural financial markets, and some of the common causes. Even though there a wide variety of programs, policies and institutions are used in many low income countries, progress has been limited due to several incorrect and/or untested assumptions. A new strategy has been proposed by Dale and others that includes more emphasis on savings mobilization, higher and more flexible interest rates, greater attention to borrowing costs rather than interest rates, and more incentives for lending by existing institutions with less concern for creation of new specialized ones.

These changes will certainly never resolve all the agricultural development problems of low income countries. It is unrealistic to believe that finance can do that anyway, particularly in a country like Nepal where the natural resource and ecological constraints are so obvious. But sound, progressive rural financial markets would be a step in the right direction.

REFERENCES

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